RESEARCH HIGHLIGHTS

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ETHICAL AND SOCIAL FUND INVESTMENTS IN LOWER-TO-MODERATE INCOME AFFORDABLE RENTAL HOUSING IN CANADA: AN ASSESSMENT

(Completed under the CMHC External Research Program)

Introduction

This CMHC External Research Program study examines the feasibility of encouraging equity investment in lower-to-moderate income affordable rental housing (ARH) in Canada, within the framework of a public-private partnership (PPP) model, using ethical or socially responsible investment (SRI) funds and pension funds.

Methodology

The study examines the U.S. model for ARH PPP arrangements, with emphasis on equity investment. Ethical investment industries in both the U.S. and Canada are examined in detail. Specific U.S. fund investment structures are reviewed and Canadian ones are surveyed. The regulatory, legislative and investment environments in Canada are assessed. Options for structuring equity investments for Canadian ethical funds are explored. For this study, a literature search was undertaken and a 13-question survey sent to Canadian fund managers of ethical and SRI pension investments.

While only five organizations participated, the responses provide insights into topics like assets managed, legislation, financial incentives and disincentives, appropriate investment vehicles, rate of return and exit strategy considerations. In addition, informal interviews with staff of other investment management firms, mutual and real estate fund managers, real estate investment trusts (REITs), developers and industry organizations provided additional information. Conceptually, however, ethical/ social investment funds do not make equity investments in real estate, nor have they contemplated doing so.

Findings

1. The U.S. Model for ARH PPPs

The U.S. model for ARH PPP investment is a community-based, "joint effort" between a wide variety of public, quasi-public, and private sector organizations. The private sector developer is a central figure in ARH PPPs. Achievement of affordable rent targets established by the government in the U.S. is pursued primarily from the supply side through capital subsidies and lower cost equity financing, rather than from the demand side through rent subsidies. Equity investments in ARH PPPs are encouraged by:

(1) the federal Low Income Housing Tax Credit (LIHTC), which provides tax relief for investors making equity investments in affordable housing; and

(2) the *Community Reinvestment Act* (CRA), which encourages regulated financial institutions to make ARH equity investments.

Because of the large number of stakeholders in ARH PPPs, private sector co-ordinating syndicates have evolved to assist with equity and other financing, project development and implementation. Such syndicates typically operate equity funds with financing from a variety of sources, including

investors motivated by tax credit incentives. The National Community Development Initiative (NCDI) coordinates major U.S. corporations and foundations, Housing and Urban Development (HUD) plus scores of local public and private organizations in joint equity ARH financing.

An important feature of the LIHTC is that it is not sufficient, by itself, to permit qualifying projects to achieve affordability targets. Developers, with the aid of syndicates and community development organizations, must assemble additional equity and debt financing from a variety of sources to obtain approval. This fosters competition among developers, as well as a general partnering environment.

In Canada, development of PPP structures for affordable housing is slowly evolving, but lags considerably behind the U.S. situation. One major initiative was the formation within CHMC, in 1991, of the Canadian Centre for Public-Private Partnership in Housing (CCPPPH) to actively encourage and support groups interested in developing affordable housing.

2. Structure of the Ethical/SRI Industry in the U.S. and Canada

Ethical or socially responsible investing is a big and rapidly growing business in comparison to the overall investment market in both countries. In the U.S., SRI currently accounts for 13 per cent of all professionally managed investments and totalled $2.2 trillion (U.S.) in assets in 1999. In Canada, the SRI industry accounted for $50 billion (Cdn) in investments in 2000, which comprised just over three per cent of total professionally managed investment assets. The industry in Canada is approximately one-third the size of that in the U.S. in relative terms and less than one-sixtieth the size in absolute terms (after exchange rate adjustments).

Screening and shareholder advocacy are overwhelmingly the most common forms of SRI activity in the U.S., accounting for over 99 per cent of total screened mutual funds investments. Screening involves the application of social and environmental guidelines as underlying considerations. Shareholder advocacy involves active investor participation in management decisions and business practices. In Canada, shareholder advocacy is less common and evidence suggests that SRI activity is focussed on screening. Affordable housing is not an identified screening criterion for SRI funds in either country.

Affordable housing investments (including rental accommodation) comprise only a minuscule component of total SRI investment in both countries. Community development investment, of which affordable rental housing is one component, totals $54 billion in the U.S. and accounts for less than 0.3 per cent of total SRI assets. In Canada, community development investments total only $85 million and affordable owned and rented housing is a small portion of that amount.

U.S. initiatives within the SRI industry are currently increasing community development investments. Investors involved in screening and advocacy are being encouraged to allocate at least one per cent to community development. If successful, this could triple the amount of community development SRI.

The composition of the SRI industry in Canada is:

- 55 per cent in-house pension funds and other institutional investors;
- 22 per cent investment management firms;
- 21 per cent retail investment funds (split between screened mutual funds and labour-sponsored venture capital funds); and
- 2 per cent other.

In 2001, there were 47 retail investment funds in Canada functioning as SRI funds. The majority of retail funds were small but a few were large.

3. Equity Investment in ARH by U.S. Ethical and SRI Pension Funds

Selected ethical and SRI funds, including mutual funds, loan funds and pension funds, were chosen for study because of their current involvement in ARH investments, although the degree of involvement varied considerably. Clearly, affordable housing is a relatively undeveloped investment component. All of the funds reviewed made only debt (not equity) SRI investments.

There are some regulatory obstacles to SRI equity investments in ARH. Mutual funds cannot invest directly in real estate, although they can through real estate investment trusts (REITs), or diversified corporate or foundation structures. While pension funds can invest through a variety of trusts, partnership and corporate vehicles (including REITs), they cannot develop real estate directly.

The unfavourable risk/return characteristic of ARH investments is a problem in all categories of SRIs except loan funds, which pay below market returns and assume higher degrees of risk. Several organizations expressed concern with the length of the equity ARH investment period. The need for liquidity is also a problem in the case of pension funds. Several respondents referred to the need for improved investment instruments such as secondary-market securitization, sort of a "Fannie Mae for equity investments". Other obstacles cited were the minimum fund size required, the lack of suitable investments and well-motivated partners and, the complexity of existing ARH partnership arrangements.

The study's author felt, that the best way to encourage SRI investments in ARH PPP arrangements is through some type of REIT vehicle. Such investments could also be eligible for LIHTC type credits transferred from developers, although this would add considerably to their complexity. Rates of return guarantees are also a possibility. REITs, structured as corporations in the U.S., are eligible investments for all categories of SRI investments.

REITs have a number of inherent advantages. As marketable securities, they significantly lessen liquidity problems. This feature also eliminates the required lock-in period for equity investments under the LIHTC. Also, REITs are compatible with PPP arrangements and would significantly reduce complexity problems for investors who could participate as developers or as less active participants.

4. Prospects for Equity Investments by Ethical and SRI Pension Funds in Canada

A review of Canadian prospects for ethical and social fund investments in ARH through PPP arrangements indicates that Canada lags behind the U.S. and is only in the early stages of developing a framework compatible with its institutional and regulatory environment.

Canada does not have broad-based incentives to encourage equity investment in ARH PPPs comparable to U.S. ones. There is no legislation similar to the *Community Investment Act* (CRA) to induce financial institutions to make investments in affordable housing. Nor is there a general financial incentive comparable to the LIHTC. However, even in the relatively advanced U.S. situation, there has been very little success in attracting equity investment by ethical and SRI pension funds.

In the Canadian regulatory/legislative environment for ethical funds and SRI pension funds, there are three primary commercial sources of equity capital for ARH PPPs:

(1) in-house institutional investors, primarily pension funds;

(2) socially screened mutual funds; and

(3) pooled funds managed by investment management firms.

Regulatory rules and income tax legislation governing the funds place constraints on their ability to make equity investments in real estate. But there are a number of options for structuring ARH equity investments. All funds can invest in non-taxable REITs and pension funds have additional choices, including investing through non-taxable real estate investment corporations (REICs) that provide full liability protection.

Investment regulations governing pension funds make it impossible for them to invest equity in ARH arrangements, other than accepting deferred returns of profits paid out over a longer period of time. Similarly, as regulated commercial operations that frequently invest retirement savings, mutual funds must make sound investments on market-comparable terms

Summary of Survey Findings

Surveyed Canadian organizations were favourably inclined towards the concept of an equity ethical fund for investment in ARH, with the proviso that such investments must be properly structured. Four out of five respondents stated that the principal obstacle is the poor risk/return prospects associated with ARH investments. A second major obstacle for them was the lack of an appropriate investment framework. There was a consensus that government incentives were required to encourage equity ARH investments. These four funds were evenly split as to whether tax incentives or investment guarantees would encourage equity investment. Several funds noted that investment guarantees alone would be unlikely to result in significant rent reductions. Respondents had no clear or strong opinions on the preferred type of investment instrument for ARH equity investments.

Respondents held mixed views on investors' willingness to make concessions when investing in ARH. Most believed that institutional investors would be willing to make concessions with respect to deferred returns and some individual investors might be willing to make other concessions such as reduced returns rather than higher risk. However, there would be regulatory obstacles. In more widespread discussions with the investment industry, the view was that ethical investing should not involve any concessions to risk or return. To the contrary, many ethical funds argued that ethical investing should enhance investment returns and security.

In regard to the investment commitment period, the dominant view was that funds would have to be committed for a long period, possibly in excess of twenty years. An effective market trading arrangement for a closed-end fund (for example, a REIT) would be helpful in providing liquidity. A strong secondary market for equity securities (a "Fannie Mae for equities") would also be important.

Survey respondents estimated the amount they might allocate to equity ARH investments under ideal circumstances. Three of the funds suggested a percentage of fund assets varying from one-quarter of one per cent to three per cent,

and one to two percent in the case of pension funds. These figures are interesting in light of the U.S. ethical industry which encourages ethical funds to allocate one per cent of their assets to community development, including affordable housing. In Canada, such an allocation could result in $125 million in equity financing for affordable housing

Three existing investment funds currently make equity real estate investments (REIT and REIC vehicles plus a grandfathered open-ended mutual fund trust) that could be used as models for structuring future ethical fund equity investments in ARH arrangements.

The study examines potential investment arrangements and incentives for Canadian ethical and SRI pension investments. The primary options included various forms of tax credits or direct government grants. Other options that would reduce the risk of equity ARH investments for funds were government equity guarantees to investors of capital-return and rate-of-return guarantees. However, all of these options would require policy, regulatory and legislative changes in Canada.

Conclusion

The primary conclusion of this study is that ethical and social fund equity investments are conceptually feasible however, both Canada and the U.S. have a long way to go in developing the necessary regulatory and investment frameworks and incentive structures.

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